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14. ABSTRACT

Despite recent rhetoric touting the imminent displacement of the U.S. Dollar (USD) by the Renminbi (RMB) as the global reserve currency, this paper argues that the Chinese effort to internationalize its currency does not pose a credible threat to USD hegemony nor U.S. vital interests due to the inadequacy of Chinese financial institutions and policies, and the resiliency inherent to the dollar-dominated system. Further, this paper argues that despite the conventional threat assessment that internationalization of the Renminbi poses a direct challenge to the USD's financial hegemony and U.S. global influence, it is not actually China's intent to promote the RMB as the leading global reserve currency, but that China has a more limited aim of self-sufficiency within a Chinese regional sphere of influence. This paper concludes with a series of attainable policy recommendations to strengthen the USD's position and unquestionably deter future currency challengers addressing the U.S.'s overuse of financial sanctions, the politization of the U.S. debt-ceiling debate, and the necessity for pricing current and future commodities in USD.

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De-Dollarization, Currency Hegemony, China, Renminbi, Global Reserve Currency

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"Internationalization of the Renminbi and the effects on U.S. dollar hegemony and U.S. vital interests"

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INTRODUCTION

For nearly 80 years, the United States (U.S.) has benefited immensely from the U.S. Dollar's (USD) status as *the* global reserve currency. The costs associated with ensuring the stability and ubiquity of the USD in global financial markets are greatly outweighed by its benefits and give the U.S. unique levers of influence in foreign affairs.[1] Over the past decade, much research has been conducted regarding how Russia and China have sought to "de-dollarize" their economies to circumvent economic sanctions and shift influence away from the United States.[2] Despite recent rhetoric touting the imminent displacement of the dollar by the Renminbi (RMB)[3], this paper will argue that the Chinese effort to internationalize its currency does not pose a credible threat to USD hegemony nor U.S. vital interests due to the inadequacy of Chinese financial institutions and policies, and the resiliency inherent to the dollar-dominated system. Further, this paper will argue that despite the conventional threat assessment that internationalization of the Renminbi poses a direct challenge to the USD's financial hegemony and U.S. global influence, it is not actually China's intent to promote the RMB as the leading global reserve currency but that China has a more limited aim of self-sufficiency within a Chinese regional sphere of influence.[4] This paper will conclude with a series of attainable policy

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[1] Rebecca M Nelson and Karen M Sutter, "De-Dollarization Efforts in China and Russia" (Congressional Research Service, July 23, 2021), https://crsreports.congress.gov/product/pdf/IF/IF11885.
[2] Nelson and Sutter, "De-Dollarization Efforts".
[3] "*Renminbi* literally means "people's money" and is the name of the Chinese currency. The unit of account is the *yuan*. For an analogy, consider the British currency, which is the pound sterling, whereas the unit of account is the pound." For the purposes of this paper, yuan and Renminbi will be used interchangeably. Eswar Prasad, *The Dollar Trap: How the U.S. Dollar Tightened Its Grip on Global Finance* (Princeton, NJ: Princeton University Press, 2015), 26.
[4] Diana Choyleva and Dinny McMahon, "China's Quest for Self-Reliance: How Beijing Plans to Decouple from the Dollar-Based Global Trading and Financial System," Wilsoncenter.org (Wilson Center and Enodo Economics, August 2022), https://www.wilsoncenter.org/sites/default/files/media/uploads/documents/Enodo%20Economics_China%27s%20Quest%20for%20Financial%20Self-reliance_August%202022.pdf, vii.

recommendations to strengthen the USD's position and unquestionably deter future currency challengers.

IMPLICATIONS OF THE U.S. DOLLAR AS THE GLOBAL RESERVE CURRENCY

Before delving into the potential challenges facing dollar hegemony, it is useful to understand how the USD is used in global financial markets and how it is uniquely beneficial in the execution of U.S. policy. For perspective, "about half of international trade is invoiced in dollars, [and] about half of all international loans and global debt securities are denominated in dollars."[5] Further, the dollar accounted for almost 90% of global foreign currency exchanges (FX) despite the U.S. only accounting for about 10% of global trade.[6] It is essential to emphasize that most global financial transactions, even those in which the United States is not a party, are conducted in USD. In this sense, the USD is a "vehicle currency in foreign exchange, meaning that non-US dollar currency pairs are not exchanged directly, but via the dollar."[7]

The dominance of the USD has given the U.S what foreign governments have described pejoratively as an "exorbitant privilege."[8] Specifically, this privilege refers to the fact that the U.S. has an outsized ability to finance its annual budget deficits to pursue national objectives through the issuance of Treasury Bonds and set monetary policy without regard for how it affects global affairs or concern for balance-of-payment issues.[9] Due to so many dollars circulating in global financial markets searching for a reliable investment, the perceived trust in the U.S.

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[5] Rebecca M Nelson and Martin A Weiss, "U.S. Dollar as the World's Dominant Reserve Currency," Congressional Research Service, September 15, 2022, https://crsreports.congress.gov/product/pdf/if/if11707.

[6] Bafundi Maronoti, "Revisiting the International Role of the US Dollar," The Bank for International Settlements, December 5, 2022, https://www.bis.org/publ/qtrpdf/r_qt2212x.htm.

[7] Maronoti, "Revisiting the International Role of the US Dollar".

[8] Ben S. Bernanke, "The Dollar's International Role: An 'Exorbitant Privilege'?" (Brookings, July 29, 2016), https://www.brookings.edu/blog/ben-bernanke/2016/01/07/the-dollars-international-role-an-exorbitant-privilege-2/.

[9] Michael Hudson, *Super Imperialism: The Origin and Fundamentals of U.S. World Dominance*, 2nd ed. (London, U.K.: Pluto Press, 2003), xii.

Government's financial backing and the liquidity of Treasuries ensures the United States can run consistent balance-of-payment deficits with little consequence.[10]

The dollar's status as the global reserve currency and the volume of transactions conducted in dollars also gives the United States a unique and unmatched ability to impose financial sanctions over states and actors it perceives as acting against U.S. national interests.[11] Further, the U.S. has both the visibility of dollar movements and influence over entities that dominate the "plumbing" of the global financial network: Society for Worldwide International Financial Telecommunications (SWIFT) and Clearing House Interbank Payment System (CHIPS).[12] The recent isolation of Russia from the USD-dominated financial system has led China to see its dependence on the USD as a strategic vulnerability.[13] China's primary geostrategic ambition to reunify Taiwan with the mainland has led Beijing to believe this vulnerability and ambition are incompatible. Thus, the concerted effort by China to internationalize the RMB was reborn from a false start in 2009 after the global financial crisis.[14]

INHIBITORS TO CHINA'S CHALLENGE OF THE FINANCIAL STATUS QUO

The inhibitors to the successful internationalization of the RMB are significant. China still exercises control over capital flows in and out of the mainland, and significantly, its financial markets need more breadth, depth, and liquidity.[15] China has traditionally exercised relatively tight capital controls and utilizes an onshore market (Mainland) and offshore market (through Hong Kong) to implement restrictions on capital movements. In contrast, "an open

[10] Bernanke, "The Dollar's International Role: An 'Exorbitant Privilege'?".
[11] Nelson and Sutter, "De-Dollarization Efforts".
[12] Choyleva and McMahon, "China's Quest for Self-Reliance", 127-128.
[13] Choyleva and McMahon, "China's Quest for Self-Reliance," vii.
[14] Choyleva and McMahon, "China's Quest for Self-Reliance", viii.
[15] Eswar Prasad, *The Dollar Trap: How the U.S. Dollar Tightened Its Grip on Global Finance* (Princeton, NJ: Princeton University Press, 2015), 230, 240.

capital account has minimal restrictions on cross-border capital flows, implying that the domestic currency can be freely converted into foreign currencies (or vice versa) at market exchange rates."[16]

China has been loosening, but not eliminating, restrictions on capital flows.[17] Specifically, Chinese Communist Party (CCP) leadership allows capital outflows for currency appreciation mitigation measures resulting from trade surpluses but still exercises oversight and control.[18] Beijing has also slowly let capital flow inbound over the past 20 years. While always welcoming foreign direct investment, China has traditionally made the process onerous and restrictive to who could invest and controlled how quickly foreign investors could repatriate profits.[19] Recently, China has opened multiple pathways for foreign investment through stocks, bonds, and other financial channels, but almost all require purchases in RMB.[20] This requirement bodes well for the RMB's use in cross-border trade as it puts more yuan in circulation. However, the perceived ability of the CCP to re-implement restrictions at the first sign of trouble does not lend universal trust to the exchange of capital, and trust is still essential for institutional investors. Liu assesses, "that China remains comfortable using capital outflow controls is a serious concern for foreign investors—including central banks—since controls have implications for liquidity. For instance, outflow controls restrict investors' ability to sell renminbi-denominated assets and exchange the proceeds for foreign currencies. When used, they can effectively lock investors' capital in China."[21]

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[16] Prasad, *The Dollar Trap*, 231.
[17] Prasad, *The Dollar Trap*, 231.
[18] Prasad, *The Dollar Trap*, 232.
[19] Prasad, *The Dollar Trap*, 232.
[20] Choyleva and McMahon, "China's Quest for Self-Reliance", ix.
[21] Serena Liu, "What Is Holding the Yuan Back? Xi Is.," Georgetown Journal of International Affairs, February 9, 2022, https://gjia.georgetown.edu/2022/02/11/what-is-holding-the-yuan-back-xi-is/.

A "weak link" in the Renminbi project for greater internationalization is China's underdeveloped financial markets compared to the U.S. and other developed economies.[22] To be attractive to foreign investors, a market must have *Breadth*, or "a broad range of financial instruments, including markets for hedging risk;" *Depth*, meaning "a large volume of financial instruments in specific markets;" and, most importantly, *Liquidity*, referring to "a high volume of turnover (trading volume)."[23] China is making strides in all three areas but lags behind the U.S. by all measures. To attract real institutional investments, China must be able to issue high-quality government and corporate debt that, in turn, would enable more RMB to enter the market, much like the United States does to finance budget deficits and increased circulation of USD.

In many ways, the dollar is everything that the yuan is not. At its core, the dollar is backed by trust and an independent central bank, whereas the yuan lacks independence and is subject to increasingly singular autocratic influence. The foreign investor, particularly the institutional investor, is looking for a safe store of value, predictable returns, and is politically agnostic. The United States offers these investors a "system of checks and balances among the different arms of government, together with an open and transparent democratic process, [that] has created a sense of confidence in U.S. public institutions. The rule of law is firmly established, with even the executive branch being subject to the dictates of the law."[24] An investment in the United States will be guaranteed by laws and not written down by dictate.

This is not to say that the fiscal and monetary policies of the United States are perfect, but it is all relative. The U.S. has the prime-mover advantage, deep and broad financial markets, unmatched liquidity, and is the biggest beneficiary of network effects supported by the dollar-

[22] Prasad, *The Dollar Trap*, 240.
[23] Prasad, *The Dollar Trap*, 240.
[24] Prasad, *The Dollar Trap*, 14.

dominated system.[25] Illustrative of this fact is that during the 2008 financial crisis, dollars flowed *into* the United States in search of a safe store of value through government debt.[26] Where common sense would assume capital would flow away from the cause of a financial crisis, the opposite happened. The dollar-dominated system is self-supporting, self-protecting, and self-perpetuating.

REASSESSING CHINA'S FINANCIAL AMBITIONS

China's reluctance to relinquish control over capital flows, foreign investors' lack of trust in its under-developed financial institutions, and the RMB's inability to compete with the USD outright have led to China's current initiative of multiple state-controlled bilateral trade agreements conducted in RMB. One may characterize this as "open-capital markets with Chinese characteristics" to appropriate a description often applied when analyzing China's particular application of established concepts. China's true goal is not to replace the dollar as the global reserve currency but to carve out a regional sphere where the U.S. does not have the free exercise of influence it currently enjoys in the dollar-dominated system.[27]

A critical enabler to the Chinese efforts to build a self-sufficient and China-centric network was creating a parallel cross-border payment exchange that excluded the USD and, by extension, U.S. influence. This system was created in 2015 by the People's Bank of China (PBoC) and is known as the Cross-Border Interbank Payment System (CIPS).[28] In many respects, CIPS combines SWIFT (how banks talk to one another) and CHIPS (the actual clearing

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[25] Barry J. Eichengreen, Arnaud Mehl, and Livia Chitu, *How Global Currencies Work: Past, Present, and Future* (Princeton: Princeton University Press, 2018), 5.
[26] Prasad, *The Dollar Trap*, 19.
[27] Choyleva and McMahon, "China's Quest for Self-Reliance", 29.
[28] Choyleva and McMahon, "China's Quest for Self-Reliance", 126.

of exchange balances between banks). CIPS provides several advantages to the Chinese and many participating countries.

First, it is run entirely by the PBoC (by extension, the CCP) without direct influence by the United States or the West. This attribute is particularly attractive to countries such as Russia, which need a way to circumvent U.S. sanctions to sustain its war against Ukraine.[29] CIPS is increasingly attractive to firms and banks that wish to continue relations with sanctioned entities but fear U.S. retaliation of secondary sanctions through information garnered by the U.S.'s access to SWIFT databases.[30] Interestingly, CIPS enables separate countries to conduct bilateral trade without China but still use the yuan.[31] This construct promotes RMB internationalization by increasing FX turnover and weakens the U.S.-dominated system by circumventing sanctions enforcement.

Second, CIPS "reduces the costs and increases the speed of cross-border transactions" through bilateral currency swaps with participating countries without utilizing the dollar.[32] One primary reason so much trade is conducted in USD is that the tremendous volume of dollars available for conversion keeps conversion costs low. The market laws of supply and demand apply and are one of the main reasons that dollar hegemony will not likely be replaced. To account for this cost-differential and the associated risk (lack of transparency and trust) of a CCP-controlled exchange, China must offer a more compelling reason for foreign countries to conduct bilateral currency exchanges using the yuan.

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[29] Choyleva and McMahon, "China's Quest for Self-Reliance", 129.
[30] Choyleva and McMahon, "China's Quest for Self-Reliance", 129.
[31] Choyleva and McMahon, "China's Quest for Self-Reliance", 129.
[32] Choyleva and McMahon, "China's Quest for Self-Reliance", 126.

REPURPOSING THE BELT AND ROAD INITIATIVE

China's original vision for the Belt and Road Initiative (BRI) was to export excess Chinese *infrastructure capacity* to meet the developing world's needs outside its borders. In the process, China sought to gain influence and increase RMB internationalization. This goal largely failed to come to fruition. Because of the vast preference for the dollar by loan recipients (and their contractors, suppliers, etc.), most Chinese BRI loans were denominated in USD.

By contrast, a reimagined BRI strategy currently being touted by the PBoC's Director of the Institute of Finance, Zhou Chengjun, inserts a dynamic component to the lending referred to as "industrial capacity cooperation."[33] Choyleva and McMahon identify several economic pressures that have led to this reimagining of BRI:

- "China's rapidly aging population and shrinking workforce mean it will increasingly need to move low-end industries to economies with cheaper labor.
- Industries that intensively consume inputs which China lacks – namely energy, water, and land – can relocate to developing economies without such constraints.
- As China pursues decarbonization and a cleaner environment, pressure will mount to move polluting industries to countries with lower environmental standards.
- China can help develop extraction and processing facilities for resources it lacks in countries within its sphere of influence."[34]

Under this new construct, China would offshore *industrial capacity* and the associated environmental degradation in key areas it lacks naturally, i.e., iron ore, oil, natural gas, cobalt, etc., through a closed loop vectored by the yuan. Zhou, summarized succinctly by Choyleva and McMahon, envisions the cycle as such: "A Chinese bank makes a loan to a foreign borrower in yuan, the foreign recipient uses the funds to buy plant and machinery from Chinese suppliers, the newly constructed industrial facility sells its product to Chinese buyers who pay for it in yuan,

[33] Choyleva and McMahon, "China's Quest for Self-Reliance", 90.
[34] Choyleva and McMahon, "China's Quest for Self-Reliance", 90.

and the overseas borrower uses its yuan-denominated revenue stream to repay its yuan-denominated loans.[35] What is implied in this cycle is that China would become the end-consumer, not the intermediary as it has been in the past. This will allow China to leverage its growing consumer economy and achieve self-sufficiency within its sphere, separate from U.S. and Western interference. In time, excess yuan derived from these projects could be invested in China's broadening and deepening debt market, and the cycle continues. From China's perspective, this construct mitigates the lack of trust issue of foreign institutional investors not in the Chinese sphere of influence by largely ignoring the need for them. Foreign investments from BRI initiatives are vetted, controlled, and beholden to China through the CCP and the dictated use of RMB in all financial transactions.

The logic of this new BRI imagining is sound if not unconventional when assessed within the context of the established financial system that largely relies on trust and a free market. However, this proposed system *is* in line with China's overall need to circulate RMB outside its borders. The degree of success with this initiative will determine if RMB internationalization and use will become more akin to the Euro, or stagnate like the Yen, in their respective debuts as reserve currencies. However, due to China's lack of transparency and early stage of strategy development, Choyleva and McMahon acknowledge it is impossible to know the true extent and long-term viability of this reimagined initiative but contend "it could be a particularly useful model in resource-rich countries like Russia and Iran that have been cut off from using dollars."[36]

[35] Choyleva and McMahon, "China's Quest for Self-Reliance", 91.
[36] Choyleva and McMahon, "China's Quest for Self-Reliance", 91.

COUNTER ARGUMENT

History provides several examples of the displacement of the dominant global reserve currency with a common thread of currency decline associated with empire decline. An empire in decline loses international appeal for investment as doubts arise concerning its long-term prospects.[37] The most recent example of the transition from the British Pound Sterling to the dollar is illuminating when viewed over the decades between World Wars I and II. Bretton Woods codified the dollar's arrival in 1944, but the USD steadily grew in market share from the 1920s onward.[38] The U.S. was poised, willing, and able to assume global reserve currency status with the appropriate financial instruments in place to couple with an unrivaled economy as Great Britain steadily declined. How different does this look for the China-U.S. relationship today?

China certainly has an economy to rival the United States, and as previously stated, has been developing the financial systems and institutions to carry out regional bilateral trade in RMB. The underlying structure is available, and RMB internationalization has increased in the last decade. RMB is now the "fourth most commonly used currency in global payments, according to SWIFT, up from 35th in October 2010. The yuan rose to a record 3.2% of international payment settlements in January [2022], breaking a record set in 2015."[39] When taken in context relative to the other three leading currencies of the Dollar, Euro, and Yen, the Renminbi may have a long way to go if it were to aspire to global reserve currency status. However, one must remember that China's cultural memory and strategic patience are measured

[37] Gal Luft and Anne Korin, *De-Dollarization: The Revolt against the Dollar and the Rise of a New Financial World Order*, 2019, xxii.
[38] Luft and Korin, "De-Dollarization", xxiii.
[39] Zennon Kapron, "China's Targeted Renminbi Internationalization Is Feasible," Forbes (Forbes Magazine, December 2, 2022), https://www.forbes.com/sites/zennonkapron/2022/12/01/chinas-targeted-renminbi-internationalization-is-feasible/?sh=5b2b79c538e5.

in centuries rather than decades. The fact remains that China has put the mechanisms in place to do so should the appropriate internal and external conditions arise.

Rebuttal

Despite increases in editorial and public rhetoric concerning the United States' decline in influence abroad, reality does not align with an assessment that the U.S. is an empire in decline and that China is ready and willing to displace the dollar with the yuan. For the foreseeable future, the United States can continue to manage its debt-to-GDP ratio and successfully finance its military expenditures to protect its interests. Recall that the United States, in both the 2008 financial crisis and the 2020 pandemic, used its considerable influence and financial tools to inject liquidity and stability into markets for the benefit of all. In times of crisis, investments flow *into* the United States. In this regard, there is no corollary when assessing China.

While the basic structures exist to allow the RMB to steadily internationalize in a Chinese regional sphere of influence, fundamental financial policy positions controlled by the CCP will inhibit the RMB from achieving global reserve currency status. If this ever becomes China's intent, the CCP would need to adopt open capital controls, run consistent trade deficits in RMB-denominated trade, and minimize state manipulation and control of its currency and financial markets. As the CCP is unwilling to cede these controls and implement these reforms, it will settle for an incremental opening of markets and focus on regional bilateral trade in RMB that it feels will foster self-reliance and shield it from any possible U.S. interference.

ATTAINABLE POLICY GOALS TO ENSURE DOLLAR HEGEMONY

For the reasons enumerated in this paper, the U.S. should not be overly concerned with increased cross-border transactions settled in RMB and the incremental internationalization of yuan. However, maintaining the status quo dominance of the dollar necessitates evaluating the current and future environment to adapt to pacing competitors to minimize vulnerabilities. The U.S. must re-evaluate its domestic and foreign policies regarding economic sanctions, public debt, and commodity pricing and implement attainable policy goals to deter rising currency challenger coalitions.

The U.S. has overplayed its hand regarding financial sanctions and must adjust its strategy toward financial behavior modification. The overuse of sanctions has incentivized targeted entities to seek and develop alternative systems to circumvent U.S. control and has decreased the use of the USD as a vehicle currency. At a minimum, the U.S. should review the effectiveness of its current sanctions programs through an interagency cost-benefit analysis perspective and carefully consider the future application of sanctions in light of the creation of institutions such as CIPS. By contrast, other financial and economic tools, such as aid and developmental financing, should be increased to gain influence with key partners in vital regions of strategic competition. While the United States may see financial sanctions as a behavior modification tool, its targets increasingly interpret these actions as a weaponization of the dollar. They are the driving force behind many countries' de-dollarization efforts.[40].

The political posturing associated with the debt-ceiling debate in the last decade has publicly started undermining the foundational institution of trust in the USD. Trust that debts will be repaid and are fully backed by the U.S. Government is the engine of USD circulation, dollar debt financing, and overall influence of the U.S. globally. Annual budget deficits and growing national debt should be actively managed through expenditure analysis and tax policies during the budget and appropriations process. However, it should be actively communicated and

[40] Luft and Korin, "De-Dollarization", 1.

understood that the *politicization* of arbitrary debt-ceiling limits weakens the United States.

Commodity pricing in USD uniquely benefits the U.S. as producers, consumers, and futures pricing are most easily compared and hedged against when all prices are set in one currency.[41] Specifically, the U.S. must be aware of all non-dollar-denominated oil transactions and use all levels of influence over Saudi Arabia to continue to defend the pricing of its oil in USD.[42] The volume of oil and other commodities priced in USD perpetually reinforces the U.S.'s deficit debt financing cycle. Any significant and unified action against commodity pricing in USD must be addressed quickly through diplomatic engagement. Further, the U.S. must gain market share as the commodity pricing of emerging minerals necessary for the shift to renewable energy, such as cobalt and lithium, sourced from developing economies.[43]

CONCLUSION

The U.S. should not be overly concerned that the incremental internationalization of the Renminbi will displace the USD as the dominant global reserve currency, nor will it significantly affect U.S. vital interests. As China seeks to increase bilateral trade within a Chinese sphere of influence, the relative share of the USD in the world economy will decrease, but the dollar will not be replaced. Chinese financial institutions are inadequate in breadth, depth, and liquidity and are based on an inherently opaque CCP-controlled system. This lack of a genuinely open capital market and lack of trust by foreign investors will keep the RMB from fully internationalizing. Knowing this, China has realized that its reliance on the dollar poses a strategic vulnerability to U.S. sanctions in the context of potential conflict. It has subsequently developed an alternative

[41] Daniel Fried, "The U.S. Dollar as an International Currency and Its Economic Effects," Congressional Budget Office Working Papers (Congressional Budget Office, April 17, 2023), https://www.cbo.gov/system/files/2023-04/58764.pdf, 4.
[42] Luft and Korin, *De-Dollarization*, 154.
[43] Choyleva and McMahon, "China's Quest for Self-Reliance", 87.

cross-border payment system independent of U.S. influence for use in a regional Chinese sphere of influence.

The resiliency, robustness, and transparency of the U.S.-led financial system will ensure the USD remains the global reserve currency if it is carefully managed and defended by policymakers. The U.S. must leverage its relative strengths with its partners to maintain the status quo and deter any overt challenges to a dollar-denominated pricing system. Dollar hegemony has provided stability to the financial world. It will continue to do so despite the incremental internationalization of the Renminbi.

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